STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petitions of C. CZARNIKOW, INC. for Redetermination of Deficiencies or for Refund of Corporation Franchise Tax under Article 9-A of the Tax Law for the Fiscal Years Ended September 30, 1981 through September 30, 1985.	: : : : : :	DETERMINATION

Petitioner, C. Czarnikow, Inc., 77 Water Street, New York, New York 10005, filed petitions for redetermination of deficiencies or for refund of corporation franchise tax under Article 9-A of the Tax Law for the fiscal years ended September 30, 1981 through September 30, 1985 (File Nos. 802174 and 806000).

A hearing was held before Jean Corigliano, Administrative Law Judge, at the offices of the Division of Tax Appeals, Two World Trade Center, New York, New York, on May 2, 1989 at 9:15 A.M., with all briefs to be submitted by September 22, 1989. Petitioner appeared by Burton G. Lipsky, Esq. The Division of Taxation appeared by William F. Collins, Esq., (Anne W. Murphy, Esq., of counsel).

ISSUES

I. Whether income received by petitioner from repurchase agreements is allocated properly by petitioner's investment allocation percentage or business allocation percentage.

II. Whether income received by petitioner from demand notes issued by petitioner's grandparent corporation is allocated properly by petitioner's investment allocation percentage or business allocation percentage.

III. Whether the Division of Taxation properly allocated petitioner's net operating loss deduction between business and investment income for the fiscal year ended September 30, 1982.

FINDINGS OF FACT

Petitioner, C. Czarnikow, Inc., and the Division of Taxation entered into a stipulation of facts which is substantially incorporated into this determination. There are no facts in dispute.

Following a field audit of petitioner's books and records, the Division, on March 18, 1985, issued to petitioner two notices of deficiency. The first asserted tax due for the fiscal year ended September 30, 1981 in the amount of $45,109.00 plus interest. The second notice asserted tax due for the fiscal year ended September 30, 1982 in the amount of $32,601.00 plus interest.

A second field audit covering fiscal years 1982, 1983 and 1984 resulted in the Division issuing the following notices of deficiency to petitioner on March 6, 1987:

Period Ended	Tax Amount	Interest	Total
9/30/83	$19,446.00	$8,117.00	$27,563.00
9/30/83	3,500.00*	1,461.00	4,961.00
9/30/84	10,203.00	2,726.00	12,929.00
9/30/84	1,734.00*	463.00	2,197.00
9/30/85	2,457.00	315.00	2,772.00
9/30/85	418.00*	54.00	472.00

*Metropolitan transit tax surcharge

Petitioner, a New York corporation, is a commodities trader and broker, dealing primarily in sugar. It began doing business in 1978 as Christman Trading Corporation. Hanmark Commodity Corporation was a general corporate partner and minority stockholder of Christman Trading Corporation. Hanmark is the financial holding company of C. Czarnikow, Limited ("Limited"), a United Kingdom corporation which is Hanmark's sole shareholder. In October 1980, Hanmark acquired all of the stock of Christman Trading Corporation which then changed its name to C. Czarnikow, Inc.

As a commodities broker, petitioner needed to maintain large amounts of readily available cash, and it was able to project its need for cash on a daily basis. During the fiscal years ended September 30, 1981 and September 30, 1982, it was petitioner's policy to conduct a daily review of its need for cash for the following business day and to place any unneeded funds in repurchase agreements. Petitioner executed its repurchase agreements with Chase Manhattan Bank, N.A. and Morgan Guaranty Trust Company of New York. These transactions were structured in the following manner. Petitioner agreed to purchase certain United States government securities from its bank and simultaneously agreed to sell the same securities to the same party at a specified resale price on an agreed future date. Generally, the agreement was for repurchase on the following business day. The resale price generally exceeded the purchase price by an amount which reflected an agreed upon interest rate for the term of the repurchase agreement. Petitioner submitted several representative repurchase agreements. The samples refer to the dollar amounts placed in the repurchase agreements as either "principle" or "quantity". There is no discernible relationship between the dollar amounts placed in the agreements and the fair market value of the government securities sold or between the stipulated interest rate and the coupon yield on the underlying government securities as shown on the repurchase agreement. The record does not establish whether there was an actual transfer of possession of the underlying securities from the banks to petitioner.

The repurchase agreements entered into by petitioner were similar to repurchase agreements actively traded in the over-the-counter market.

Late in its fiscal year ended September 1981, petitioner changed its policy with regard to funds not immediately needed in its business operations. At that time, petitioner began placing excess funds in demand notes issues by its grandparent corporation, Limited. Limited, like petitioner, was a commodities broker with a need for large amounts of working capital. The rate of return on the demand notes was negotiated by petitioner and Limited. It was set at a rate that enabled Limited to obtain capital at an interest rate lower than that charged by Limited's banks in the United Kingdom while providing petitioner with a rate of return higher than that which it was earning on the repurchase agreements.

Although petitioner and the Division stipulated that the demand notes at issue are similar to those traded in the over-the-counter market, there is no evidence that the demand notes issued by Limited were ever sold in a private placement market.

The corporation franchise tax report filed by petitioner for the fiscal year ended September 30, 1981 reported total investment capital of $2,830,460.00. This was allocated to cash in the amount of $2,371,830.00, consisting entirely of funds placed in the repurchase agreements, and the fair market value of demand notes held by petitioner and issued by its grandparent corporation, Limited, amounting to $458,630.00. Petitioner reported an investment allocation percentage of zero for this period. Petitioner's corporation franchise tax report for the fiscal year ended September 30, 1982 reported investments in stock issued by unrelated companies as well as cash in the form of the repurchase agreements and the demand notes issued by Limited. For the fiscal year ended September 30, 1982, petitioner computed an investment allocation percentage of 0.0134.

During the years in issue, petitioner treated income it received from the repurchase agreements and demand notes as investment income. The amounts it received in each category are shown below.

YEAR	REPURCHASE AGREEMENTS	DEMAND NOTES
1981	$714,894.00	$ 88,715.00
1982	160,958.00	613,850.00
1983		369,378.00
1984		340,906.00
1985		224,920.00

On the first audit, the Division reclassified petitioner's income from the repurchase agreements as business income and allocated that income by a business allocation percentage. On both audits, the Division took the position that notes of a related corporation are items of business capital. Consequently, the Division treated the fair market value of Limited's demand notes as business capital, and it treated the interest income on demand notes issued by Limited as business income and allocated it by a business allocation percentage.

On June 2, 1988, a conciliation conference was held covering the first audit period under consideration here. As a result of information submitted by petitioner at this conference, the tax asserted for the fiscal year ended September 30, 1983 was reduced, resulting in a refund due to petitioner in the amount of $2,497.00. The refund was based on the carry back of a net operating loss sustained by petitioner in 1986 to the fiscal year ended September 30, 1983. Petitioner claims a refund for this period in the amount of $12,498.00. Petitioner's calculation of its refund claim is based upon its treatment of the demand notes as investment capital and the interest income from those notes as investment income.

On April 25, 1986, petitioner filed a claim for credit or refund of corporation tax for the fiscal year ended September 30, 1982 in the amount of $84,520.00. Petitioner's claim was based upon the application of a New York net operating loss of $1,747,345.00 sustained by petitioner in the fiscal year ended September 30, 1985 to the fiscal year ended September 30, 1982.

Petitioner and the Division agreed to recalculate petitioner's refund claim for the fiscal year ended September 30, 1982 as if the Division had prevailed on the issues to be determined here. However, if it is determined that petitioner's income from the repurchase agreements and demand notes is properly classified as business income, the parties nevertheless disagree about the correct method of calculating the refund due to petitioner.

A taxpayer with both business income and investment income must apportion a net operating loss between the two before deducting the loss. The method of apportioning the loss differs depending on whether the tax would have been measured by entire net income or by entire net income plus officer's compensation before deducting any net operating loss. It is petitioner's position that the tax here would have been measured by entire net income, and the Division's position that the tax would have been measured by entire net income plus officer's compensation. This disagreement explains the difference in the amount of the refund calculated by each party.

Petitioner calculates a corporation franchise tax liability for the fiscal year ended September 30, 1982 of $32,252.00, entitling petitioner to a refund of $56,340.00. The Division computes a tax due for the same period of $34,957.00, entitling petitioner to a refund due of $53,635.00.

Petitioner also protested assessment number C8505020600 in the amount of $269.25 for the fiscal year ended September 30, 1984. The Division conceded that this tax was paid, and it asserted that the assessment had been or would be canceled.

CONCLUSIONS OF LAW

A. For the tax years at issue, section 210 of the Tax Law provided four alternative methods of computing the corporation franchise tax imposed under article 9-A. The first of the four alternative methods is computed on the basis of the corporation's entire net income (Tax Law § 210.1[a][1]). The second alternative is computed on the basis of the taxpayer's total business capital and investment capital (Tax Law § 210.1[a][2]). The third alternative is computed on the basis of entire net income plus compensation to officers (Tax Law § 210.1[a][3]). The fourth alternative is a flat minimum tax (Tax Law § 210.1[a][4]). The taxpayer is required to use whichever of the four alternative methods yields the greatest amount of tax.

Regardless of the method used, the Tax Law permits the corporate taxpayer to separately allocate its business income and capital, investment income and capital, and subsidiary capital so that corporations are subject to tax only on the portion of their activities attributable to New York. Petitioner computed its franchise tax liability on the basis of entire net income. It categorized the repurchase agreements and demand notes at issue here as investment capital and allocated income it received from its interest in those instruments by its investment allocation percentage. Accordingly, the issues to be decided here are, first, whether each instrument is properly classified as an item of investment capital, and second, if the first question is answered affirmatively, whether petitioner properly allocated income it received from its interest in each instrument by its investment allocation percentage.

B. The Division argues that petitioner's interests in repurchase agreements are properly classified as business capital, while petitioner argues that such interests are investment capital. Insofar as pertinent here, investment capital means investment in stocks, bonds and other securities (Tax Law § 208.5), and business capital means all assets, other than subsidiary capital, investment capital and stock issued by the taxpayer, except that "cash on hand and on deposit shall be treated as investment capital or as business capital as the taxpayer may elect" (Tax Law § 208.7). The regulations defining investment capital state: "At the election of the taxpayer, cash on hand and cash on deposit may be treated on any report as investment capital or business capital.... Certificates of deposit are deemed to be cash" (20 NYCRR 3-4.2[d]).

C. While petitioner argued, as a matter of law, that the repurchase agreements are properly classified as "other securities", it treated these instruments as cash on deposit for purposes of calculating its corporation franchise taxes for fiscal years 1980 and 1981. Preliminarily then, the first question to be answered is whether cash placed in the repurchase agreements may be deemed to be cash on deposit; if so, petitioner was entitled to treat such cash as investment capital in accordance with Tax Law § 208.7.

The term "cash on deposit" as it is used in Tax Law § 208.7 is not defined by statute or regulation. Where this occurs, the words used in the statute "may be given their ordinary meaning, with any ambiguity to be construed most strongly in favor of the taxpayer and against the government" (Manhattan Cable TV Services v. Freyberg, 49 NY2d 868, 869). To the ordinary reader, cash on deposit must mean nothing more than cash deposited in a bank or similar institution, both for safekeeping and to earn income. In determining whether repurchase agreements are the equivalent of cash on deposit, it is proper to look to the function of these instruments, to search for substance over form with emphasis on economic reality (see, Matter of Avon Products v. State Tax Commn., 90 AD2d 393, 394-395; United Housing Foundation v. Forman, 421 US 837).

Here, petitioner was placing excess funds in repurchase agreements for short periods of time ranging from overnight to several days. Petitioner's purposes in doing so were to obtain the highest rate of return possible on a short-term investment while maintaining the liquidity necessary for its business. The formal terms of the repurchase agreements established a contract to purchase and sell back government securities, but in actuality, petitioner deposited money with its banks and earned interest income on the money so deposited, just as it would if it had purchased a certificate of deposit. Functionally then, there is no discernible difference between the repurchase agreements at issue here and cash on deposit. Accordingly, petitioner was entitled to treat monies placed in the repurchase agreements as cash on deposit, and it was entitled under the authority of Tax Law § 208.7 to categorize its interests in the repurchase agreements as investment capital. However, this conclusion does not end our inquiry.

The regulations governing the use of the investment allocation percentage state: "A taxpayer may allocate its investment income and investment capital within and without New York State by the investment allocation percentage." (20 NYCRR 4-7.1[a]). The investment allocation percentage is computed by dividing "the average fair market value of the taxpayer's total investments in stocks, bonds and other securities issued by any corporation, except the taxpayer, its subsidiaries or a DISC" allocated to New York State by the average fair market value of the taxpayer's total investment in each corporation (20 NYCRR 4-7.2[a][1], [2]; emphasis added). Accordingly, while cash on deposit may be treated as investment capital for purposes of allocation, it is not considered in computing the investment allocation percentage. This explains the seemingly anomalous situation here, where petitioner computed an investment allocation percentage of zero for its 1980 fiscal year and then applied this zero percentage to its income from repurchase agreements which it categorized as investment income from income on bank accounts. In this situation, petitioner was required to allocate its income from the repurchase agreements by its business allocation percentage. The regulation regarding allocation of entire net income provides in pertinent part: "When the investment allocation percentage is zero, interest received on bank accounts [essentially, interest from cash on deposit]...is multiplied by the business allocation percentage." (20 NYCRR 4-8.1[d].)

The outcome here would be different if monies placed in the repurchase agreements were deemed to be investments in "other securities" as opposed to cash on deposit. In that case, monies placed in the repurchase agreements would appropriately be considered in calculating the investment allocation percentage. Therefore, petitioner's argument that repurchase agreements are "other securities" for purposes of Tax Law § 208.5 must also be considered.

D. The statutory term "other securities" is defined by regulation as:

> "securities issued by governmental bodies and securities issued by corporations of a like nature as stocks and bonds, which are customarily sold in the open market or on a recognized exchange, designed as a means of investment, and issued for the purpose of financing corporate enterprises and providing a distribution of rights in, or obligations of, such enterprises" (20 NYCRR 3-4.2[c]).

Included in the definition are, among others, "debentures, notes of a type commonly dealt in upon securities exchanges" and "other instruments evidencing proprietary rights in corporate enterprises which have many of the essential characteristics of stock" (20 NYCRR 3-4.2[c]). Excluded from the definition are:

> "corporate obligations not commonly known as securities, such as real property bonds and mortgages, chattel bonds and mortgages, contracts of sale, purchase money obligations, short-term notes...bills of lading, bills of exchange, bankers' acceptances and other commercial instruments" (20 NYCRR 3-4.2[c]).

In the most recent case treating this subject, the Appellate Division, Third Department held that the cited regulation "is in harmony with the spirit and purpose of the statute" (Matter of Carret & Company v. State Tax Commn., 148 AD2d 40, 543 NYS2d 216). The court stated that the test for determining whether an interest is a security is "whether there is 'an investment of money in a common enterprise with profits to come solely from the efforts of others'" (Matter of Carret & Company v. State Tax Commn., supra, quoting Securities and Exchange Commission v. Howey Co., 328 US 293, 301, 66 S Ct 1100). This is known as the Howey test. In the Carret decision, the Court also looked to whether the instrument was for financing a corporate enterprise or for a distribution of rights or obligations in the enterprise as an indication of whether the interest was a security in substance as well as form. The application of these principles leads to the conclusion that the repurchase agreements entered into by petitioner were not "other securities" within the meaning of Tax Law § 208.5.

To begin, it is necessary to look at the actual substance of the repurchase agreements. While structured as a sale of securities, there was no evidence in the record to show that petitioner actually took possession of the underlying securities, had the right to dispose of the securities, or assumed the risk of a profit or loss. Consequently, the repurchase agreements must be viewed as separate financial instruments which did not receive the characteristics of the underlying securities (cf., Andras v. Illinois Department of Revenue, 154 Ill App 3d 37, 506 NE2d 439). The question then is whether the repurchase agreements themselves evidence an investment in a common enterprise with profits to come from the effort of others. Clearly, they did not. The repurchase agreements were not designed to finance a corporate enterprise in the same way that stocks and bonds are designed to do so, and they did not in themselves distribute rights or obligations in a common enterprise. In fact, testimony presented by petitioner showed that the repurchase agreements most closely resembled an ordinary bank deposit with petitioner earning interest on its money by granting its banks use of that money for a certain period of time.

In sum, the repurchase agreements were properly treated as investment capital but excluded from the computation of petitioner's investment allocation percentage in both the 1980 and 1981 tax year. Since this percentage was zero in the 1980 tax year, income received from the repurchase agreements for the fiscal year ended September 30, 1981 was allocated properly by petitioner's business allocation percentage. Petitioner's investment allocation for the fiscal year ended September 30, 1982 is greater than zero; therefore, investment income was allocated properly by petitioner's investment allocation percentage.

E. The next issue to be addressed is whether petitioner properly classified the demand notes issued by Limited as investment capital. In order to prevail on this issue, petitioner was required to prove that these instruments fell within the statutory definition of investment capital as defined above (see, Mobil International Finance Corporation v. New York State Tax Commission, 117 AD2d 103, 501 NYS2d 947). Since it is evident that the demand notes were neither stocks nor bonds of Limited, the issue distills to whether these demand notes were "other securities" as that term is used in Tax Law § 208.5 and defined by regulation (see, 20 NYCRR 3-4.2[c]).

To support its contention that the demand notes were "other securities", petitioner asserted that: (1) the notes were of a type commonly traded in an over-the-counter market; (2) the notes were designed as a means of investment; and (3) the notes were issued by Limited for the purpose of financing its business enterprises. It is the opinion of this determination that petitioner's proof fell far short of proving that the demand notes at issue fall within the definition of "other securities".

Although the parties stipulated that the demand notes are of a type sold in the over-the-counter market, there is no evidence that Limited's notes were ever held by anyone other than petitioner or that Limited's notes were ever sold in any private placement market. Petitioner's motive in acquiring the demand notes was to invest money and earn a profit, but such motive does not prove that the demand notes were investment capital within the meaning of Tax Law § 208.5 (see, Matter of Carret & Company v. State Tax Commn., supra). Nor is it sufficient that Limited issued the demand notes to finance its own business activities. The regulation includes within the definition of "other securities" "debentures [and] notes of a type commonly dealt in upon securities exchanges" while excluding such corporate obligations as "property bonds and mortgages, chattel bonds and mortgages, contracts of sale, purchase money obligations [and] short-term notes" (20 NYCRR 3-4.2[c]). To succeed in proving that the demand notes were "other securities" within the meaning of the Tax Law, it was incumbent upon petitioner to prove that the investment instrument was intended to distribute rights and obligations in the corporate enterprise and to offer an opportunity to share in the profits of an enterprise managed by others (see, Matter of Carret & Company v. State Tax Commn., supra; 20 NYCRR 3-4.2[c]; see also, Securities and Exchange Commission v. Howey, supra). Petitioner presented no evidence of the precise nature and terms of the demand notes and, therefore, failed to carry its burden of proof. It is concluded that the Division properly treated the demand notes as intercompany loans made in the regular course of business rather than items of investment capital.

F. The regulations concerning the net operating loss deduction of taxpayers with business and investment income provide:

> "Before deducting any net operating loss, a taxpayer with both business income and investment income in a taxable year to which a loss is carried back or carried forward must apportion the loss between business and investment income. There are two methods of apportioning the loss. The method which must be used depends upon the measure by which the taxpayer would have paid its tax before deducting any net operating loss." (20 NYCRR 3-8.8; emphasis added).

In calculating the refund due petitioner for the fiscal year ended September 30, 1982, the Division calculated petitioner's tax liability by each of two methods. First, the Division allocated the net operating loss by the method appropriate if the tax were measured by entire net income and computed petitioner's taxable income accordingly. Then it allocated the net operating loss by the method appropriate if the tax were measured by entire net income plus compensation paid to officers and computed petitioner's taxable income accordingly. As the latter method yielded the greater amount of tax, this method was selected to calculate petitioner's tax liability and refund. It is petitioner's position that the method selected to allocate the loss is dependent upon the measure by which the petitioner would have paid its tax before deducting any net operating loss (i.e., by the measure which would yield the greatest tax before application of the net operating loss). Neither party submitted legal argument on this issue, but only petitioner's position is supported by the clear wording of the regulation.

G. In accordance with the order of the Bureau of Conciliation and Mediation Service, the Division is directed to grant petitioner a refund in the amount of $2,497.00 for the fiscal year ended September 30, 1983.

H. In accordance with Conclusion of Law "D", the Division is directed to recalculate petitioner's franchise tax liability for the fiscal year ended September 30, 1982, treating cash placed in the repurchase agreements as investment capital and allocating the income from the repurchase agreements by the investment allocation percentage. In doing so, the Division will take into account petitioner's 1985 New York net operating loss carried back to fiscal year ended September 30, 1982 and compute the refund in accordance with Conclusion of Law "F".

I. The petitions of C. Czarnikow, Inc. are granted to the extent indicated in Conclusions of Law "D", "F", "G" and "H"; the notices of deficiency issued on March 18, 1985 and March 6, 1987 shall be modified accordingly; in accordance with Finding of Fact "17", assessment number C8505020600 is canceled; and in all other respects, the petitions are denied.

DATED: Troy, New York
February 22, 1990

/s/ Jean Corigliano
ADMINISTRATIVE LAW JUDGE